

**In the United States Court of Appeals
for the Ninth Circuit**

HARBOR PLYWOOD CORPORATION, a Corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

**On Petition for Review of the Decision of the Tax Court
of the United States**

BRIEF FOR THE RESPONDENT

Theron Lamar Caudle,
Assistant Attorney General.

Ellis N. Slack,
Lee A. Jackson,
Harry Baum,

*Special Assistants to the
Attorney General.*



INDEX

	Page
Opinion Below	1
Jurisdiction	1
Question Presented	2
Statute and Regulations Involved	2
Statement	2
Summary of Argument	5
Argument:	
The Tax Court correctly held that the income in question accrued in the years taxpayer's right to receive it arose, not in the years it was received and reported	6
A. The applicable principles	6
B. The record amply supports the Tax Court's conclusion ---	15
1. The right to receive the income arose in the taxable years	16
2. There was a reasonable expectancy of payment of the amounts receivable	18
3. The cases relied upon by taxpayer furnish no basis for reversal	21
4. The doctrine of "constructive receipt" is inapplicable --	23
C. In no event did the income accrue in the years taxpayer reported it	23
Conclusion	24
Appendix	25

CITATIONS

CASES:

<i>American Cigar Co. v. Commissioner</i> , 66 F. 2d 425, certiorari denied, 290 U. S. 699	13
<i>Automobile Ins. Co. v. Commissioner</i> , 72 F. 2d 265	12, 15
<i>Barker v. Magruder</i> , 95 F. 2d 122	12, 15
<i>Brown v. Helvering</i> , 291 U. S. 193	7
<i>Brunton v. Commissioner</i> , 42 F. 2d 81	13
<i>Clark v. Woodward Construction Co.</i> , 179 F. 2d 176	13, 14, 17
<i>Clifton Mfg. Co. v. Commissioner</i> , 137 F. 2d 290	13
<i>Commissioner v. Brooklyn Union Gas Co.</i> , 62 F. 2d 505	13
<i>Continental Tie & L. Co. v. United States</i> , 286 U. S. 290	7, 10, 15
<i>Franklin County Distilling Co. v. Commissioner</i> , 125 F. 2d 800	11, 14
<i>Frost Lumber Industries v. Commissioner</i> , 128 F. 2d 693	13
<i>Georgia School-Book Depository, Inc. v. Commissioner</i> , 1 T. C. 463	14, 21
<i>Helvering v. Russian Finance & Construction Corp.</i> , 77 F. 2d 324	13

	Page
<i>Lichtenberger-Ferguson Co. v. Welch</i> , 54 F. 2d 570	13
<i>Liebes, H., & Co. v. Commissioner</i> , 90 F. 2d 932	8, 15, 18, 22, 23
<i>Louisville Property Co. v. Commissioner</i> , 140 F. 2d 547, certiorari denied, 322 U. S. 755	22
<i>Pacific Forest Industries v. Commissioner</i> , decided November 4, 1941	19
<i>Peyton Du-Pont Securities Co. v. Commissioner</i> , 66 F. 2d 718 ..	13
<i>Rogers v. Commissioner</i> , 103 F. 2d 790, certiorari denied, 308 U. S. 580	22
<i>San Joaquin Valley Poultry Producers' Assn. v. Commissioner</i> , 136 F. 2d 382	19
<i>Security Mills Co. v. Commissioner</i> , 321 U. S. 281	7
<i>Spring City Co. v. Commissioner</i> , 292 U. S. 182	7, 9, 14, 17
<i>United States v. Amalgamated Sugar Co.</i> , 72 F. 2d 755	13, 14, 17
<i>United States v. Anderson</i> , 269 U. S. 422	7

STATUTE:

Internal Revenue Code:

Sec. 21 (26 U.S.C. 1946 ed., Sec. 21)	6, 25
Sec. 23 (26 U.S.C. 1946 ed., Sec. 23)	14
Sec. 41 (26 U.S.C. 1946 ed., Sec. 41)	6, 25
Sec. 42 (26 U.S.C. 1946 ed., Sec. 42)	6, 25
Sec. 43 (26 U.S.C. 1946 ed., Sec. 43)	6, 26
Sec. 48 (26 U.S.C. 1946 ed., Sec. 48)	6, 26
Sec. 3806 (26 U.S.C. 1946 ed., Sec. 3806)	17

MISCELLANEOUS:

2 Mertens, Law of Federal Income Taxation (1942):

Sec. 10.01	23
Sec. 10.02	23
Sec. 12.01	7
Sec. 12.07	7
Sec. 12.08	7

Treasury Regulations 111:

Sec. 29.23(k)-2	14
Sec. 29.42-1	7, 26
Sec. 29.43-1	7, 27

**In the United States Court of Appeals
for the Ninth Circuit**

No. 12,660

HARBOR PLYWOOD CORPORATION, a Corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

**On Petition for Review of the Decision of the Tax Court
of the United States**

BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the Tax Court (R. 124-133) is reported at 14 T. C. 158.

JURISDICTION

This petition for review (R. 140-147) involves federal excess profits tax liability for the years 1943 and 1944, and income tax liability for the year 1945. The Commissioner's notices of deficiencies were mailed to the taxpayer on July 23, 1948. (R. 12.) Within ninety

days thereafter, and on October 20, 1948, taxpayer filed its petition with the Tax Court for redetermination of the deficiencies, under the provisions of Section 272 of the Internal Revenue Code. (R. 4-15.) The decision of the Tax Court sustaining the deficiencies was entered April 25, 1950. (R. 139.) The case is brought to this Court by petition for review filed July 17, 1950 (R. 140-147), pursuant to the provisions of Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether taxpayer, filing its returns on the "accrual" basis, may postpone reporting income earned by and credited to it in the taxable years until the years in which the income was actually collected, because of a possibility that the amounts credited might not be collected.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.

STATEMENT

The facts as stipulated (R. 25-82) and found by the Tax Court (R. 125-129) may be summarized as follows:

Taxpayer-corporation, a manufacturer and distributor of plywood and other building materials, keeps its books and files its returns on the accrual and calendar year basis. (R. 125-126.) It is one of about twenty-five stockholder-members of Pacific Forest Industries (hereinafter called "Pacific"), a cooperative selling association organized for the purpose of exporting plywood and other forest products for its members, as authorized by the Webb Export Trade Act. Pacific's income consists of commissions on sales made on behalf

of its members, and it keeps its books on the basis of a fiscal year ending March 31st. Its by-laws provide that if the commissions received by it in any year exceed selling costs, the excess must (unless the board of trustees directs otherwise) be returned or credited to the members as an addition to the purchase price of the merchandise sold by them. (R. 51-52, 126-127.)

At the close of each of its fiscal years 1943, 1944, and 1945, Pacific issued to taxpayer a credit memorandum for amounts representing taxpayer's proportionate share of the excessive commissions which had been charged to the members on sales of their products during the year. These amounts were credited to taxpayer on the books of Pacific as of the dates the credit memoranda were issued, and were claimed and allowed as exclusions from Pacific's gross income in its tax returns for those years. (R. 33-35, 127.)

In issuing to taxpayer the credit memorandum of March 31, 1943, Pacific wrote taxpayer as follows (R. 127-128) :

We are pleased to enclose Credit Memorandum to cover price adjustment on orders supplied by you and shipped by us during the period April 1st, 1942, through March 31st, 1943. * * *

May we point out, however, that the Treasury Department has filed with us a request for renegotiation of the contracts which we have accepted and are filling. It is, therefore, impossible to distribute the additional price evidenced by the enclosed Credit Memorandum until the results of the renegotiation are known. We believe, however, that the results will be favorable since, in the first place, we are a non-profit organization and secondly, all plywood which we have shipped has gone outside the Continental United States and thus the con-

tracts should not be subject to renegotiation under the law.

Each of the other credit memoranda for the fiscal years 1944 and 1945 was issued subject to the same restriction as to payment. (R. 128.)

Prior to issuing the credit memoranda to taxpayer, Pacific received a letter from the War Department Price Adjustment Board, requesting that it submit information on the basis of which the War Department could determine whether Pacific's contracts were entitled to clearance or subject to renegotiation. (R. 57-60.) Renewed requests for such information were sent in 1943 by the Treasury Department Price Adjustment Board. (R. 64-71.) In May of 1944, Pacific wrote its members that "A statement is being filed this month with the Price Adjustment Board of the Treasury Department which it is hoped will result in clearance." (R. 76-77.) In June of 1944 the Treasury Department Price Adjustment Board advised Pacific that upon review of the information submitted "no further action is contemplated." (R. 77-78.) Pacific at all times maintained that it was not subject to renegotiation and was finally sustained on that contention. (R. 128, 130.) The renegotiation of Pacific for its fiscal years ended 1943, 1944, and 1945 was barred by the running of the statute of limitations on March 31, 1944, May 11, 1945, and May 29, 1946, respectively. (R. 128.)

Pacific paid the 1943 credit memorandum in 1944. It paid the 1944 and 1945 credit memoranda in 1946. The delay in payment beyond the dates of expiration of the statute of limitations on renegotiation was due to the fact that Pacific had not collected for all of its sales and did not have sufficient cash on hand to make the payments sooner. (R. 128-129.)

Taxpayer reported the amounts credited to it in the years they were paid. The Commissioner determined that the amounts accrued and were taxable to taxpayer in the years when the credit memoranda were issued. (R. 129.) The Tax Court, one Judge dissenting, sustained the Commissioner's determination. (R. 129-133.)¹

SUMMARY OF ARGUMENT

It is settled that a taxpayer reporting on the "accrual" basis must accrue and report income in the taxable year in which his right to receive it becomes fixed, irrespective of whether or when it is eventually received, if there is a reasonable expectancy of its receipt. If the account receivable turns out to be uncollectible, the taxpayer may have a deduction in the year it becomes uncollectible, but the income accrues in the year the right to receive it arose. The record unquestionably warrants the Tax Court's conclusion that taxpayer's right to receive the income here involved arose in the taxable years (not in the years taxpayer received and reported it), and that there was a reasonable expectancy of its receipt. All the events fixing taxpayer's right to receive and the amounts receivable had occurred; indeed, taxpayer's debtor (Pacific) formally acknowledged the amounts to be owing by issuing credit memoranda to taxpayer. That Pacific delayed payment of the amounts credited pending determination of whether its profits were subject to renegotiation did not affect taxpayer's right to receive (and corre-

¹ It is stipulated that if the income in question is not taxable either in the years the credit memoranda were issued, as the Tax Court held, or in the years they were paid, as taxpayer contends, then they are taxable in the years when renegotiation of Pacific's income was barred by the statute of limitations; and the amount of the deficiencies in such event has also been stipulated (R. 29-30.)

sponding duty to accrue) the amounts credited, but only the prospects of collecting the full amounts receivable. Moreover, taxpayer had every reason to expect ultimate payment since, as the documentary exhibits show, and the Tax Court found, there existed nothing more than a bare possibility (which never materialized) of renegotiation of Pacific's contracts. That possibility no more justifies postponement of the year of accrual to the year of actual receipt than does any other possibility of non-collection of an account receivable. To tie the date of accrual to the date of actual receipt, merely because of a possibility that the income may not be collected, would in effect erase the basic difference between the "cash" and "accrual" systems of tax accounting. Even assuming that the amounts credited did not accrue until the years in which renegotiation of Pacific's profits was barred by the statute of limitations, taxpayer still cannot prevail, for it did not report the income in those years but in later years when it was actually received. Taxpayer's contention that there was no "constructive receipt" of the income in the taxable years is addressed to a straw issue; the doctrine of constructive receipt applies only to taxpayers reporting on the cash receipts and disbursements basis. Taxpayer points to no authority which warrants reversal of the decision below.

ARGUMENT

The Tax Court Correctly Held That the Income in Question Accrued in the Years Taxpayer's Right to Receive It Arose, Not in the Years It Was Received and Reported.

A. The applicable principles.

Code Section 21 (Appendix, *infra*) defines net income as the gross income less allowable deductions. Sections 41, 42, and 43 (Appendix, *infra*) require net income to be computed on the basis of annual account-

ing periods (calendar or fiscal year), in accordance with the method of accounting regularly employed by the taxpayer (cash or accrual), provided such method clearly reflects the net income for the taxable year. See also Code Section 48 (Appendix, *infra*); Sections 29.42-1 and 29.43-1 of Regulations 111 under the Code (Appendix, *infra*).

The two principal recognized accounting systems are the so-called "cash" and "accrual" methods. Under the "cash" method, income is reported in the year of actual receipt and deductions are taken in the year of actual expenditure. Under the "accrual" method, income is allocated to the year in which it is earned or realized, *i.e.*, when the *right* to receive it becomes fixed, even though it is not presently receivable and irrespective of the year of actual receipt. Conversely, deduction items are allocated to the year in which they are incurred, *i.e.*, when the *liability* to pay becomes fixed, even though payment is not presently due and irrespective of the year of actual payment. *Security Mills Co. v. Commissioner*, 321 U. S. 281; *Brown v. Helvering*, 291 U. S. 193; *Spring City Co. v. Commissioner*, 292 U. S. 182; *United States v. Anderson*, 269 U. S. 422; *Continental Tie & L. Co. v. United States*, 286 U. S. 290; 2 Mertens, *Law of Federal Income Taxation* (1942), Secs. 12.01, 12.07, 12.08. Whichever method is adopted must be applied consistently. The cardinal rule is that the net income must be computed on an annual basis according to the method selected, and neither income nor deduction items may be accelerated or postponed from one taxable year to another. As the Supreme Court stated in the *Security Mills* case (pp. 286-287):

The rationale of the system is this: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the

government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.”

This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, *or applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.* (Italics ours.)

The *right to receive* income, which is determinative of when it “accrues”, is not to be confused with the prospect of its collectibility. The right to receive may become fixed both in fact and amount, although collection of all or part of the amount receivable may be uncertain. The income accrues in the year when the right to receive it arises, irrespective of whether or when it is ultimately received, so long as there was a reasonable expectancy of payment. If the account receivable later turns out to be uncollectible in whole or in part, the taxpayer may have a deduction (*e.g.*, bad debt or loss) in the year in which the receivable becomes uncollectible, but the income must be reported when the right to receive it ripens. In the words of this Court in *H. Liebes & Co. v. Commissioner*, 90 F. 2d 932, 937-938:

So far, only the right to receive has been considered. Must we also consider the prospect of realization on that right by the taxpayer? In other words, when the right to receive arises, should the fact that the right is or is not collectible be taken into consideration in determining whether income has accrued? We believe that no income

accrues unless there is a reasonable expectancy that the right will be converted into money or its equivalent. * * *

The complete definition would therefore seem to be that income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.

In the leading case of *Spring City Co. v. Commissioner, supra*, a taxpayer on the accrual basis sold goods during 1920 on open account. The vendee went into bankruptcy in December of that year, and the taxpayer-vendor was thus prohibited from enforcing payment in that year. In 1922 and 1923 the receiver in bankruptcy declared and paid dividends to the vendee's creditors, including taxpayer. In its 1920 return taxpayer claimed the sale price of the goods as a deduction, and in its returns for 1922 and 1923 it reported as income the dividends received in those years. The Supreme Court held that (1) the entire sale price accrued as income in 1920, notwithstanding that taxpayer was prevented from receiving payment in that year; and (2) taxpayer was not entitled to a bad debt deduction in 1920, but in 1923 when the final dividend was paid and the balance of the price was ascertained to be uncollectible. The Supreme Court stated (pp. 184-185, 189):

Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its

inventory is reduced and a claim for the purchase price arises. * * *

* * * If such accounts receivable become uncollectible, in whole or part, the question is one of the deduction which may be taken according to the applicable statute. * * *

* * *

Petitioner insists that "good business practice" forbade the inclusion in the taxpayer's assets of the account receivable in question or at least the part of it which was subsequently found to be uncollectible. But that is not the question here.

In *Continental Tie & L. Co. v. United States, supra*, the property of the taxpayer, a railroad company, was taken over and operated by the Federal Government during the first world war. Upon passage of the Transportation Act of 1920 it became entitled to an award by the Interstate Commerce Commission in an amount to be calculated as prescribed in that Act. It was not until 1923, however, that the Commission made an award and paid the amount to taxpayer. The Supreme Court held that the income accrued in 1920, not in the year the award was made and paid, stating (pp. 294-297):

The petitioner kept its accounts upon the accrual basis. The government insists, and the Court of Claims held, that the right to payment having ripened in 1920, the taxpayer should have returned the estimated award under section 204 as income for that year. The petitioner replies that a determination whether it would receive any award under the section and, if so, the amount of it, depended on so many contingencies that no reasonable estimate could have been made in 1920, and

that the sum ultimately ascertained should be deemed income for 1923, the year of the award and payment.

* * * Petitioner's right to payment ripened when the act became law. What sum of money that right represented is, of course, a different matter.

The petitioner says that at the date of the passage of the act it was impossible to predict that any award would be made to the railway, and, assuming one would eventuate, its amount could not be estimated, for the reason that the principles upon which awards were to be made had to be settled by the Commission and were not finally formulated until 1923. * * *

* * *

* * * But in spite of these inherent difficulties we think it was possible for a carrier to ascertain with reasonable accuracy the amount of the award to be paid by the Government.

In *Franklin County Distilling Co. v. Commissioner*, 125 F. 2d 800 (C. A. 10th), the taxpayer sold whisky in 1935 under contracts which provided that whenever the buyers chose to withdraw the whisky from the warehouse they were to reimburse taxpayer for the whisky-production tax and storage charges. The taxpayer contended that the promised amounts did not represent accrued income in 1935 because they were neither payable nor ascertainable in that year. The court held that the right to receive the income became fixed in 1935 and hence that the income accrued in that year. It stated (pp. 803-804):

Where income tax returns are made by the taxpayer on an accrual basis, there need not be certainty, but only reasonable accuracy, in calculating

an amount to be received, in order to bring that amount within taxable income. *Continental Tie & Lumber Co. v. United States*, 286 U. S. 290, 296, 297, 52 S. Ct. 529, 76 L. Ed. 1111.

Whether a taxpayer is entitled to or bound to accrue an item of income in a certain year depends upon whether there was justification for a reasonable expectation that payment of the item would be made in due course. * * *

* * *

When accounts are kept on an accrual basis, income must be accounted for in the year in which realized, although not then actually received; and deductions should be taken in the year in which the deductible items are incurred.

In *Automobile Ins. Co. v. Commissioner*, 72 F. 2d 265 (C. A. 2d), the taxpayer received an award by the German Mixed Claims Commission in 1928, payable over a number of years. The court held that the total amount of the award accrued as income in 1928 because (p. 268)—

The petitioner's right to receive the amount of its award became fixed in 1928, and there then existed reasonable ground to believe that it would ultimately be paid.

In *Barker v. Magruder*, 95 F. 2d 122 (C. A. D. C.), it was held that uncollected usurious interest was accruable as income, notwithstanding that the taxpayer had no legal right to enforce collection, since there was a reasonable expectation that interest would be paid. The court stated (p. 125) that—

though the accruals represented legally uncollectible usury, there was at all times a reasonable ex-

pectation that they would be paid, and this fact is enough to constitute them income to the same extent as if the several amounts were actually paid.

In *Clark v. Woodward Construction Co.*, 179 F. 2d 176 (C. A. 10th), the taxpayer completed work under a state highway construction contract in 1942, but under the state law was precluded from receiving final payment until expiration of a statutory notice to subcontractors who might have claims against the taxpayer. The court held that the taxpayer's right to receive payment arose, and hence the income accrued, in the year the work was completed, notwithstanding that the income was not collectible in that year and that the fund available for payment was impounded. The court stated (p. 177):

Where a taxpayer keeps his books and makes his tax returns on the accrual basis, income accrues when all events have accrued from which liability is determined and the liability has become fixed even though payment is deferred to a time in a subsequent year.

See also *Lichtenberger-Ferguson Co. v. Welch*, 54 F. 2d 570 (C. A. 9th); *Brunton v. Commissioner*, 42 F. 2d 81 (C. A. 9th); *United States v. Amalgamated Sugar Co.*, 72 F. 2d 755 (C. A. 10th); *Frost Lumber Industries v. Commissioner*, 128 F. 2d 693 (C. A. 5th); *Clifton Mfg. Co. v. Commissioner*, 137 F. 2d 290 (C. A. 4th); *Helvering v. Russian Finance & Construction Corp.*, 77 F. 2d 324 (C. A. 2d); *Peyton Du-Pont Securities Co. v. Commissioner*, 66 F. 2d 718 (C. A. 2d); *Commissioner v. Brooklyn Union Gas Co.*, 62 F. 2d 505 (C. A. 2d); *American Cigar Co. v. Commissioner*, 66 F. 2d 425 (C. A. 2d), certiorari denied, 290 U. S. 699;

Georgia School-Book Depository, Inc. v. Commissioner, 1 T. C. 463.

Taxpayer misconceives the controlling principles in contending (Br. 9-10) that it had no fixed right to receive the amounts credited to it by Pacific because "there was a contingency which might preclude ultimate payment, namely, the possible Renegotiation" of Pacific's profits. The basic fallacy in taxpayer's reasoning lies in its failure to distinguish between the right to receive income and the prospect of its eventual receipt. Income "accrues" when the right to receive it becomes definite, if there is a reasonable expectancy of its receipt. An accrual basis taxpayer who earns income, and in fact (as here) is credited by his debtor with the amount earned, is not excused from accruing and reporting the income merely because of a possibility that his debtor may thereafter become unable or unwilling to pay it.² That income earned and accrued may not be ultimately collected is a contingency which confronts every accrual basis taxpayer; the debtor might become financially unable to pay because of insolvency or (as here) because his income might be renegotiated. But uncertainty as to the collectibility of income is not tantamount to a condition precedent to the right to receive it. So long as there is a reasonable expectancy of payment it is immaterial that collection may be prevented or postponed by operation of law (e.g., *Spring City Co. v. Commissioner*, *supra*; *Clark v. Woodward Construction Co.*, *supra*), or by agreement of the parties (e.g., *Franklin County Distilling Co. v. Commissioner*, *supra*; *United States v. Amal-*

² If income accrued and reported in one year becomes uncollectible in whole or in part in a later year, the taxpayer may have a bad debt deduction in the later year. Code Section 23(k); Section 29.23(k)-2 of Regulations 111. See *Spring City Co. v. Commissioner*, *supra*.

gamated Sugar Co., supra), or by difficulties in ascertaining the amount receivable (*e.g., Continental Tie & L. Co. v. United States, supra; Automobile Ins. Co. v. Commissioner, supra*), or, for that matter, that collection is not legally enforceable at all (*e.g., Barker v. Magruder, supra*). To hold otherwise would in effect tie the year of accrual to the year of actual receipt, and erase the essential difference between the cash and accrual systems of tax accounting. What is more, it would violate the fundamental rule that items of income and deductions must be accounted for on an annual basis, regardless of the method of accounting used.

B. The record amply supports the Tax Court's conclusion.

As is plain from its opinion, the Tax Court followed the settled principles governing tax accounting on the accrual basis. Quoting from this Court's definition in the *Liebes* case, *supra*, it observed that (R. 130)—

income accrues to taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent.

Applying that rule, it concluded that the income in question accrued and was taxable to taxpayer in the years (1943-1945) when taxpayer's right to receive it became fixed, not in the years it was actually received and reported by taxpayer. (R. 130-131.) We submit that, far from being clearly erroneous as taxpayer contends, the Tax Court's conclusion is fully supported by the record. The undisputed facts show that no contingency existed as to taxpayer's right to receive the income, and that there was a reasonable expectancy of its payment.

1. *The right to receive the income arose in the taxable years.*

The facts dispositive of this case have been stipulated. Taxpayer sold merchandise through Pacific, a cooperative selling association of which it was a stockholder-member, under an arrangement whereby Pacific charged its members selling commissions. Pacific's by-laws obligated it at the end of each year to "return or credit" to the members proportionate shares of the excess of the commissions charged over selling expenses "as an addition to the purchase price of the merchandise sold by them". (R. 51-52, 126.) In compliance with that obligation and during each of the taxable years, Pacific issued to taxpayer a credit memorandum for a specified amount, representing taxpayer's pro rata share of excessive commissions. (R. 33-35, 127.) Thus all the events fixing taxpayer's right to receive the income, as well as the exact amounts receivable, occurred in the taxable years. Taxpayer's merchandise had been sold and delivered, and the amounts owing to it by Pacific "as an addition to the purchase price" were specified. If any doubt otherwise existed as to whether taxpayer's right to receive the amounts arose in the taxable years, it is dispelled by the undisputed fact that Pacific formally acknowledged the amounts to be owing in those years by issuing credit memoranda to taxpayer.

Moreover, Pacific credited the amounts to taxpayer on its books during the taxable years, and in its tax returns covering those years claimed and was allowed the amounts as exclusions from its own income. (R. 127, 130.) To be sure, as taxpayer insists (Br. 41-43), Pacific was an independent taxable entity, separate and distinct from taxpayer. But it does not follow (as taxpayer assumes) that the year in which Pacific

treated the amounts as owing to taxpayer has no bearing on the year in which taxpayer's right to receive them arose. On the contrary, that Pacific on its books and in its returns regarded itself indebted to taxpayer in the taxable years for the amounts in question serves to confirm the Tax Court's conclusion that taxpayer's right to receive the amounts arose in those years, not in some later year.

Since Pacific was required to return or credit the amounts in question to taxpayer "as an addition to the purchase price of the merchandise sold" by taxpayer through Pacific (R. 52, 126), taxpayer's position for tax purposes is essentially the same as that of any other accrual basis taxpayer who acquires an account receivable for merchandise sold and delivered. Like any other seller reporting on the accrual basis, it must accrue the purchase price when its right to receive it arises, not when its collectibility becomes certain. *Spring City Co. v. Commissioner, supra*; *Clark v. Woodward Construction Co., supra*; *United States v. Amalgamated Sugar Co., supra*. On taxpayer's theory, an accrual basis taxpayer whose debtor's profits may be renegotiated could postpone accrual of accounts receivable from that debtor until actual payment. To subscribe to such theory would render indistinguishable the accrual and the cash methods of tax accounting. Even if taxpayer itself were subject to renegotiation (and its income for the taxable years here involved had actually been renegotiated), that would not have relieved it of the duty to accrue and report the income in the first instance.³ *A fortiori*, the possibility of re-

³ Section 3806 of the Internal Revenue Code, dealing with "Mitigation of Effect of Renegotiation of War Contracts", prescribes an exclusive remedy available to taxpayers whose contracts are renegotiated. It provides that if the taxpayer is required to repay excessive profits upon a renegotiation, the amount repayable shall be

negotiation of Pacific—admittedly an independent taxpayer (Br. 41-43)—did not have that effect.

2. *There was a reasonable expectancy of payment of the amounts receivable.*

If there was a reasonable expectancy that Pacific would eventually pay the amounts which it credited to taxpayer, then under the controlling decisions taxpayer was bound to accrue and report the amounts in the taxable years, when its right to receive them became fixed. It was not justified in postponing accrual to the years of actual payment.

Taxpayer takes the position (Br. 33-39), adopted by the lone dissenting Judge below (R. 132-133), that there was no reasonable expectancy of payment of the amounts receivable because it was “highly probable” that Pacific’s contracts would be renegotiated. The contention is without merit. The documentary exhibits show (R. 57-82), as the Tax Court pointed out (R. 130), that there was nothing more than a “mere possibility” (which never materialized) of renegotiation of Pacific’s contracts. There was not only a “reasonable expectancy” (*H. Liebes & Co. v. Commissioner, supra*, p. 938) that Pacific would pay the amounts it credited to taxpayer, but every expectancy that it would do so.

Pacific credited the amounts in question to taxpayer, and offset them against its own income, notwithstanding its receipt of a letter from the War Department

treated as a reduction of the contract price for the prior taxable year in which the price was “received or accrued”, and that any resulting decrease in the tax for such prior year shall be offset against the excess profits repayable. Thus a taxpayer whose contracts are subject to renegotiation must report the contract price according to his regular method of accounting (cash or accrual) and if the contracts are later renegotiated he is entitled only to the offset relief allowed in Section 3806.

Price Adjustment Board requesting information from which that board could determine whether Pacific's contracts were subject to renegotiation. (R. 57-60.) This letter, dated December 18, 1942, stated that, pursuant to Section 403 of the Sixth Supplemental National Defense Act of 1942 as amended, Price Adjustment Boards had been established by the War, Navy, and Treasury Departments, whose function it was to conduct renegotiation proceedings with parties to contracts made with those departments; that "the objective of such proceedings is to lead to a clearance of the companies" under the Act; that "we will be glad to receive any information which you may care to submit bearing upon the matter"; and that "Such information will in any case be received without prejudice to you". (R. 58-60.) A questionnaire form to be filled out by Pacific was enclosed with this letter. (R. 61-62.) Pacific declined to furnish the requested information, claiming that it was not subject to renegotiations because it was a cooperative association exempt from income tax. (R. 65.)⁴ Renewed requests for the information were then sent by the Treasury Department Price Adjustment Board. (R. 65-66, 70-71.) In May of 1944 Pacific wrote its stockholders (including taxpayer) that "A statement is being filed this month with the Price Adjustment Board of the Treasury Department which it is hoped will result in clearance."

⁴ It is well settled that cooperative associations, such as Pacific, engaged exclusively in selling the products of its stockholder-members on a commission basis, are not taxable on income which, pursuant to their charters or by-laws, they are required to return to the stockholders each year as rebates or patronage dividends. *San Joaquin Valley Poultry Producers' Assn. v. Commissioner*, 136 F. 2d 382 (C. A. 9th). It has been so held as to Pacific itself. *Pacific Forest Industries v. Commissioner*, decided November 4, 1941 (1941 P-H B. T. A. Memorandum Decisions, par. 41,490).

(R. 76-77.) And in a letter accompanying each of the three credit memoranda issued to taxpayer Pacific stated that it would not “distribute” the amounts credited until it learned whether it was subject to renegotiation, but that it believed “the results will be favorable” because it was a non-profit organization and “should not be subject to renegotiation under the law.”

(R. 62-63, 128.) In June of 1944, long before the third credit memorandum was issued, the Price Adjustment Board wrote Pacific that upon review of the information submitted “no further action is contemplated.”

(R. 77-78.) Thereafter the amounts credited to taxpayer were paid in full by Pacific (R. 128), and taxpayer reported the amounts as income in the years they were paid (R. 129).⁵

These documentary facts unquestionably warrant the Tax Court's conclusion (R. 130) that there existed only a “possibility of renegotiation” of Pacific's income when the credit memoranda were issued to taxpayer, and that there was a reasonable expectancy of payment of the amounts credited. The burden of proving that the amounts receivable were uncollectible rested of course upon taxpayer, and it clearly failed to meet that burden. The undisputed facts that (1) Pacific at all times insisted that it was not subject to renegotiation and was sustained in that contention (R. 128, 130), and (2) issued the credit memoranda to taxpayer even after the question of renegotiation was

⁵ If, as taxpayer claims, the amounts credited to it by Pacific were not accruable because Pacific's profits might be subject to renegotiation, then it should have reported the amounts in the years renegotiation of Pacific was barred by the statute of limitations and no longer a possibility. This taxpayer did not do. Instead, it reported the amounts in later years, when it actually received payment. (R. 128-129.)

raised and subsequently paid the full amounts credited, in and of themselves amply support the decision below.

Taxpayer does not and cannot point to anything in the record to support its view that there was no reasonable expectancy of payment of the amounts credited (and actually paid) to it by Pacific. Its characterization of the letters received by Pacific from the Price Adjustment Board as "threats to renegotiate" (Br. 33) is unjustified. As is evident from the contents of the letters the Board was repeatedly requesting *information*, which Pacific had failed to supply, on the basis of which it could be determined whether Pacific's contracts were subject to renegotiation under the renegotiation statute. (R. 57-62, 65-71.) After Pacific finally supplied the requested information, it was advised by the Board that "no further action is contemplated." (R. 78.) The most that could be said in taxpayer's favor is that conflicting inferences might be drawn as to whether it could reasonably expect payment of the amounts credited to it by Pacific. Certainly it cannot be said that the Tax Court's inference was clearly erroneous.

3. The cases relied upon by taxpayer furnish no basis for reversal.

Nor does taxpayer point to any authority which calls for reversal of the decision below. The decisions upon which it chiefly relies (Br. 22-31) are those of the Tax Court, the very tribunal whose decision it here attacks. Each case in this field turns, as it must, on its own facts. Moreover, the only Tax Court case discussed by taxpayer (Br. 22-24) which bears a factual resemblance to this one is *Georgia School-Book Depository, Inc. v. Commissioner*, 1 T. C. 463, and the Tax Court's decision there is in complete accord with its decision here. At any rate, even granting that the Tax Court's decision

in this case is inconsistent with its decisions in other cases, that would still furnish no authority for reversal here, for other things being equal "one decision of the Board is entitled to as much weight as another." *Rogers v. Commissioner*, 103 F. 2d 790, 793 (C. A. 9th), certiorari denied, 308 U. S. 580. See also *Louisville Property Co. v. Commissioner*, 140 F. 2d 547, 549 (C. A. 6th), certiorari denied, 322 U. S. 755.

As for the *Liebes* case, upon which taxpayer heavily relies (Br. 11-22), the Tax Court here applied the very principles there enunciated to the undisputed facts of this case. (R. 129-130.) This Court there affirmed the Tax Court's decision that an accrual basis taxpayer which sued the Government for damages and recovered a judgment, could not accrue the amount of the judgment until the time for appeal by the Government had expired. Affirmance of the Tax Court's decision was clearly correct, since the taxpayer's claim to the income was contested and being litigated, and until the time to appeal from the judgment expired it could not be said that the taxpayer's right to receive the income had become fixed. No such situation is here presented, and there is no basis for taxpayer's attempt (Br. 21) to analogize the two cases. Taxpayer here did not have a claim which was being disputed or litigated, as did the taxpayer in the *Liebes* case. It had a claim against Pacific which Pacific *acknowledged* to be due by issuing credit memoranda to taxpayer. True, there was a possibility that Pacific's income might be renegotiated, in which event the amounts receivable might become uncollectible, but that in no way detracts from the crucial fact that taxpayer's *right* to receive the amounts in question arose in the taxable years they were credited to it and that it had reasonable expectancy of ultimate payment. Besides, taxpayer here did not report the

income in the years when renegotiation of Pacific's income was barred, as it should have done if (as it claims) the *Liebes* case is analogous. It reported the income in the years of actual receipt. (R. 128-129.)

4. *The doctrine of "constructive receipt" is inapplicable.*

Taxpayer's contention (Br. 28-31, 41-43) that there was no "constructive receipt" in the taxable years of the amounts credited to it by Pacific is beside the issue. The doctrine of constructive receipt applies only to taxpayers who report their income on the cash receipts and disbursements method, not to those reporting on the "accrual" method. See 2 Mertens, Law of Federal Income Taxation (1942), Secs. 10.01, 10.02. The Commissioner had not contended, nor did the Tax Court hold, that taxpayer constructively received the income in question in the taxable years. As the Tax Court stated (R. 131):

The question of constructive receipt is not involved. It might have been had the petitioner reported on a cash basis rather than an accrual basis.

Accordingly, the cases relied upon by taxpayer (Br. 28-31, 42) involving the question of "constructive receipt" of income by taxpayers reporting on the cash basis are patently inapposite here.

C. In no event did the income accrue in the years taxpayer reported it.

Even assuming *arguendo* that the income receivable from Pacific accrued to taxpayer in the years that renegotiation of Pacific's income was barred by the statute of limitations, taxpayer still cannot prevail. It did not report the income in those years, but in the years it actually received payment from Pacific. (R. 128-

129.)⁶ Accordingly, even if this Court should reverse the Tax Court's decision that the income accrued in the years the credit memoranda were issued, deficiencies in tax are owing by taxpayer for the taxable years in amounts which have been stipulated by the parties. (R. 29-30.)

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

Theron Lamar Caudle,
Assistant Attorney General.

Ellis N. Slack,
Lee A. Jackson,
Harry Baum,
*Special Assistants to the
Attorney General.*

DECEMBER, 1950.

⁶ Taxpayer in its brief has apparently abandoned its primary contention below that the income accrued in the years it was reported and now takes the position (Br. 9-10, 21-22), alternatively contended below, that it should have reported the income in the years renegotiation of Pacific's income became barred by the statute of limitations. The deficiencies to be entered in the event this alternative contention is sustained have been stipulated by the parties. (R. 29-30.)

APPENDIX

Internal Revenue Code:

SEC. 21. NET INCOME.

(a) *Definition*.—"Net income" means the gross income computed under section 22, less deductions allowed by Section 23.

* * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

* * *

(26 U. S. C. 1946 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General rule*.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.

* * *

* * *

(26 U. S. C. 1946 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which “paid or accrued” or “paid or incurred”, dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1946 ed., Sec. 43.)

SEC. 48. DEFINITIONS.

When used in this title—

(a) *Taxable year*.—“Taxable year” means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * *

(c) “*Paid, Incurred, Accrued*”.—The terms “paid or incurred” and “paid or accrued” shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * *

(26 U. S. C. 1946 ed., Sec. 48.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.42-1. *When Included in Gross Income*.—(a) *In General*.—Except as otherwise provided in section 42, gains, profits, and income are to be included in the

gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See sections 29.41-1 to 29.41-3, inclusive.) * * * If no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on the receipts and disbursements basis. * * * Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined, if the return is rendered on the accrual basis; or for the year in which received, if the return is rendered on the basis of cash receipts and disbursements.

* * *

Sec. 29.43-1. *“Paid or Incurred” and “Paid or Accrued.”*—(a) The terms “paid or incurred” and “paid or accrued” will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which “paid or accrued” or “paid or incurred,” unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was “paid or accrued” or “paid or incurred,” he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However,

in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * *